

The Pakistan Credit Rating Agency Limited



Currency Exchange Company Rating Methodology

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Summary

This methodology outlines PACRA's approach to assigning credit ratings to Currency Exchange Companies (CECs). The currency exchange company rating is an independent opinion on the relative credit risk of a currency exchange company. PACRA arrives at this opinion by evaluating the CEC's business and financial risks, along with an assessment of its management quality and operating environment.

Analyst Contacts

Muhammad Danish Nadeem
+92-42-3586 9504
danish.nadeem@pacra.com

The Pakistan Credit Rating Agency Limited

Head Office

FB1 Awami Complex
Usman Block, New Garden Town
Lahore
Phone +92 42 3586 9504

Karachi Office

169/1, Street No-21.
Khyaban-e-Qasim,
Phase 8, DHA, Karachi
Phone +92 346 2578624

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1. Introduction

1.1 Scope: This credit rating methodology specifically pertains to Currency Exchange Companies (CECs) operating under the regulatory framework of the State Bank of Pakistan (SBP). The establishment of CECs traces back to the Foreign Exchange Regulation Act of 1947, which laid the foundation for foreign exchange operations in Pakistan. CECs are incorporated and registered with the Securities and Exchange Commission of Pakistan (SECP) and are granted a foreign exchange license by the SBP, enabling them to conduct currency exchange transactions

1.2 Regulatory Landscape: Currency Exchange Companies (CECs) in Pakistan are regulated under the Foreign Exchange Regulation Act of 1947, drafted by SBP. There are three types of authorized entities under this Act:

- i. **Authorized Dealers:** Authorized by SBP to deal in a broad range of foreign exchange instruments.
- ii. **Authorized Money Changers:** These entities can deal in foreign currency notes and coins only, following a formal application process and payment of a fee to SBP.
- iii. **Authorized Exchange Companies:** These companies are licensed to engage in a wider array of foreign currency transactions, including the buying and selling of foreign currency notes, coins, money orders, bank drafts, traveler's cheques, and transfers. Compared to authorized money changers, exchange companies are permitted to handle more sophisticated financial instruments.

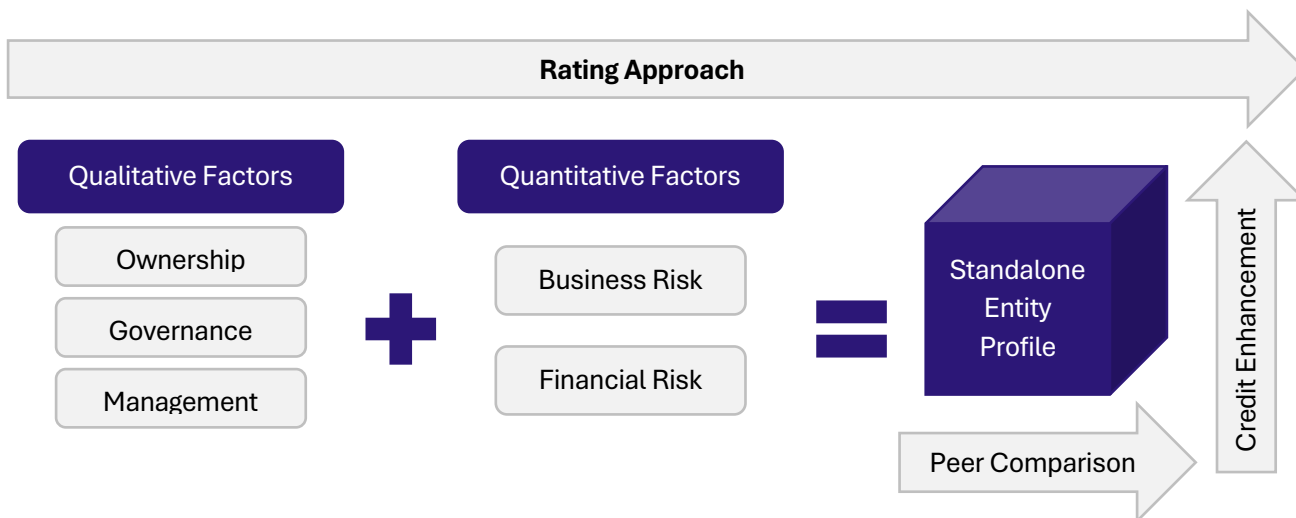
This credit rating methodology specifically pertains to Authorized Exchange Companies, which are regulated under the SBP Regulatory Framework for Exchange Companies¹. Under the Regulatory Framework, Exchange Company may commence operations within the 3 months from the date of issuance of authorization by SBP. Under the regulatory framework, exchange companies may also deal in inward and outward remittances, the export of foreign currencies other than USD, the collection of utility bills, and the installation of ATMs. Moreover, CECs are required to have a paid-up capital of PKR 1bln while maintaining minimum capital requirements of PKR 1bln on an ongoing basis. CECs can also operate from payment booths and franchise networks. Further, CECs shall maintain fifteen (15) percent of their paid-up capital as Regulatory Reserve (RR) with SBP in the form of cash and/or unencumbered approved government securities. For the purpose of maintaining RR, the company shall open the current account with SBP-BSC and maintain the Securities General Ledger Account (SGLA) facility (if required).

As per the directions of SBP, CECs are free to determine the exchange rates for buying and selling foreign currencies while maintaining a fair, reasonable, and competitive spread between these rates. Given the nature of the foreign exchange market, the operations of CECs are inherently exposed to currency fluctuations. Therefore, CECs are directed to limit their foreign exchange exposure at the close of business each day at a level not higher than 50% of their MCR as per the latest available audited financial statements. Exchange rate volatility is a fundamental characteristic of the industry and directly influences trading margins, liquidity management, and operational risk.

1.3 Rating Framework: PACRA's rating framework for CECs focuses both on qualitative and quantitative factors. These are essential towards gaining a holistic view of all factors impacting an entity on a standalone basis and within its operating environment. Herein, PACRA looks at: i) Profile, ii) Ownership, iii) Governance, iv)

¹ [Link to State Bank of Pakistan's Regulatory Framework for Exchange Companies](#)

Management, v) Business Risk, and vi) Financial Risk. Meanwhile, to ensure the element of perspective and objectivity in its assessment, PACRA incorporates an analysis of peers' CECs in its rating framework.



2. Profile

2.1 Background: PACRA reviews the background of the CEC to understand its evolution from where it started to where it currently stands. PACRA analyzes how and through what means the entity has achieved the desired expansion. PACRA looks at the progress of the entity from its historical past. The progress of the entity helps PACRA in determining the ability of the entity to successfully realize its strategy. The significant factor here for PACRA is to assess whether the entity has achieved the desired expansion through organic growth or acquisitions. Meanwhile, the source of funding for desired growth is also critical. PACRA considers the CEC's experience (more specifically, the management's experience) in the industry and views favorably those that have gained several years' track record, navigating through market cycles, developing sound processes and a well nurtured expertise to offer services. In the case of CECs that are subsidiaries of larger financial institutions, PACRA shall utilize the entity rating of the parent company to aid the rating process.

2.2 Operations: The assessment of a CEC's operations depend both on the stage of business it is in and its level of exposure to different foreign currencies. Understanding the operations helps PACRA identify potential business risks a CEC could face, its ability to safeguard its business from these risks, and its ability to attract and generate new business. PACRA reviews the diversity and geographic scope of operations, the strength and quality of the CEC's business model, franchises, licenses, standard operating procedures, policies, protocols, and product offerings.

2.3 The size of a CEC may be an important factor if it provides significant advantages in terms of competitive position and operational efficiency. PACRA also evaluates the customer experience in dealing with the firm, taking into account factors such as the quality of the facility and information availability on their online platform.

3. Qualitative Factors

3.1 The qualitative assessment helps establish the sustainability of the rating in the foreseeable future. Qualitative considerations refer to rating factors that do not pertain to an entity's business or financial risk. They

focus on internal processes, people, and systems, and are thus essential to incorporate in a forward-looking rating approach. This section provides an overview of how PACRA factors in qualitative considerations in its assessment to the extent that they can impact an issuer's ability to meet financial obligations. PACRA's detailed approach undertaken to conduct qualitative analysis is documented in its methodology titled "Qualitative Considerations".

3.2 Incorporating the potential impact of qualitative considerations into the rating opinion can be challenging, as they are inferred or estimated based on information that may be unstandardized or difficult to quantify. This requires some degree of subjectivity and analyst judgement, supplemented by PACRA's own experience and the experience of the underlying entity or other entities with similar risks. Three factors underlying PACRA's qualitative analysis at the entity level include: Ownership, Governance, and Management. The scope of analysis for each category is described below.

3.3 Ownership: The analysis of ownership is driven by the identification of the person at the last mile as the key owner and ultimate decision maker. They may not be the largest shareholder, in some cases, but would be the critical person in terms of decision-making. PACRA gauges the clarity and stability in the entity's ownership structure, succession planning at the key owner's level, the owner's experience and prowess in the underlying business and industry, and their willingness and ability to extend extraordinary financial support to the entity in distressful circumstances.

3.4 Governance: PACRA's assessment of governance involves a systematic analysis of governance data and information, along with a more contextual review of the entity's governance practices. The role of an entity's Board of Directors in providing critical and impartial oversight of management while steering the entity to its performance objectives makes it important for PACRA to look at the composition, profile, and effectiveness of the entity's Board. The Board's success in establishing a robust oversight and control framework to ensure appropriate management oversight, alignment between shareholder and management objectives, transparency in reporting and disclosures, and adherence to applicable regulatory requirements is also among the key parameters of assessment.

3.5 Management: Human expertise plays a critical role in any organization. The efficiency and reliability of processes at all levels of the organization largely rely on the effectiveness of the team set-up and the experience of the people involved. An important aspect of PACRA's analysis of CECs is therefore the management team's ability to conceive and execute stated strategies, ensure efficient coordination, and oversight. PACRA's management analysis revolves around the entity management structure, composition, and team profile. Management track record and proficiency in executing strategy, maintaining strong information systems, and utilizing the same for efficient decision making, and ensuring adherence to the entity's ethical and quality standards are considered. PACRA's management analysis also emphasizes an entity's present protocols to mitigate key-person risk. Key persons are crucial management employees whose departure from the entity can lead to impaired overall performance; strong succession planning in this regard is of paramount importance.

3.5.1 Internal Controls and Risk Management: Another major part of the evaluation of a CEC's management is the examination of the strength, independence, and effectiveness of the CEC's risk management function. PACRA evaluates the procedures and limits that have been put in place and the degree to which these procedures and limits are adhered to. More importantly, PACRA assesses the CEC's protocols set in place for foreign currency exposure management, and whether these have historically complied with the requirements

set by SBP. PACRA assesses a CEC's senior management's understanding of and involvement in risk management and examines the reporting lines in place.

Information Required for Qualitative Risk Factors:

Ownership:

- Shareholding pattern
- Details of the sponsor's other businesses
- Sponsor's financial information
- Past pattern of sponsor support

Governance:

- Composition and profile of board members
- Details of audit functions (internal and external)
- Details of Board Committees (incl. TORs) and minutes of the latest 4 meetings

Management:

- Latest organogram
- Profile of senior management
- Details of Management Committees
- Sample MIS report
- Details of management succession plans
- Details of the Risk Management function

4. Business Risk

4.1 The objective of PACRA's business risk analysis is to establish the CEC's ability to sustain and grow its relative positioning in the industry while ensuring profitable operations. PACRA also explores the possible risks and opportunities for a CEC that result from social, demographic, regulatory, and technological changes. It considers the effects of geographical diversification and trends in industry expansion, and other aspects. The analysis includes the role of the supervisory authority, its supervision of regulated entities, reporting requirements, and regulations relating to the two different types of CECs.

4.2 Industry Dynamics: The currency exchange industry is influenced by multiple factors, including the broader macroeconomic environment, regulatory frameworks, and external dependencies such as trade and remittances, along with other geopolitical considerations. These dynamics collectively shape the operational risks and profitability of CECs. Understanding how these forces interact is critical for assessing the overall risk profile of a CEC.

4.2.1 Economic Risk: Economic risk refers to the potential impact of economic factors on the market for CECs. The currency exchange industry is heavily influenced by external economic conditions such as the country's balance of payments, trade activity, and foreign currency reserves. Net inflows of foreign currencies through trade, services, and remittances are vital to maintaining liquidity in the market. Macroeconomic factors such as inflation, exchange rate volatility, and interest rate differentials directly impact the operational health of CECs. Any significant change in these variables could adversely affect the flow of foreign currency, putting pressure on CECs' financial stability.

4.2.2 Regulatory Environment: A well-regulated and supervised financial system is pivotal for the credibility and stability of CECs - even when the operating environment becomes unfavorable. PACRA pays close attention

to the extent of vigilance by SBP, along with the extent of an entity's compliance with regulatory frameworks. CECs are subject to strict regulation by the SBP, which governs their operations through foreign exchange policies and compliance requirements. The SBP places great importance on CECs complying with Anti-Money Laundering, Combating the Financing of Terrorism & Countering Proliferation Financing (AML/CFT/CPF) regulations. Thus, PACRA emphasizes the know your customer (KYC) and AML controls set in place by the CEC. Changes in currency convertibility or foreign currency movement regulations can significantly alter business conditions for CECs

4.2.3 Remittances remain a key driver of flows of foreign exchange, especially from regions like the Middle East, which account for a significant portion of Pakistan's foreign currency inflows. Economic or political instability in the Middle East may disrupt the flow of remittances, thereby potentially impacting the liquidity and operational capacity of CECs. Additionally, the growing influence of China-Pakistan Economic Corridor (CPEC) opens up new trade and investment opportunities for Pakistan, but also exposes CECs to new geopolitical risks.

4.3 Relative Position: Relative position reflects the standing of the CEC among its peers in the securities market. Institutions with stronger market standings demonstrate advantages arising from their comparatively larger scale and favorable market penetration. The stronger the relative position, the stronger the CEC's ability to sustain pressures on its business volumes, and in turn, its profit margins. The relative position takes support from the CEC's market share and growth trends.

4.3.1 Market Share: Market share represents the CEC's penetration in different geographical markets. Greater size is advantageous as it provides the ability to acquire more business, and hence have healthy pricing power and better cost management. There are positive correlations between a CEC's size (both absolute and relative), and its market position and brand value. Larger entities can exercise greater power over the pricing while ensuring proportional profits. Smaller CECs struggle to obtain business and have less flexibility in the cost structure, which can lead to their profits remaining low. While absolute size is important, the relative proportion provides a clearer yardstick for analyzing the comparative strength of market players. The larger a player is in comparison to the average, the stronger its ability to reflect the aforementioned characteristics.

4.4 Revenues: CECs have two main sources of revenue: i) income from exchange operations, and ii) fee-based income. The main components of income from exchange operations are from the sale and purchase of foreign currencies and from the gain or loss on the revaluation of foreign currencies. Income from exchange operations may also include remittance gains, which arise from the absence of real-time payments when dealing with banking firms, during which the agent may be able to charge interest or earn capital gains on remittance transactions. Fee-based income includes fees charged for providing inward and outward remittance services, along with fees from collections of local utility bill payments. Revenues are evaluated by various metrics such as revenue concentrations, comparing both core and non-core revenue with the cost of doing business or total income, analyzing revenue trends, etc.

4.5 Cost Structure: Cost structure is analyzed to assess the amount of operational flexibility of CECs, especially when in less favorable market conditions. PACRA considers the extent of the variable cost base of a CEC, while also evaluating the CEC's performance and expense ratios relative to those of its peers. This assists in understanding whether operational costs have been contained as asset bases and revenues grow. High expense ratios could be indicative of a significant fixed cost burden, and lower margins can indicate lesser flexibility regarding inflation of operational costs. Overall, a low-cost base relative to peers offers CECs greater flexibility to deal with competitive pricing pressures.

4.6 Sustainability: PACRA evaluates the strategy of the management and the viability of the designed path to reach to the CEC's long- and short-term goals. Earnings prospects are monitored based on budgets and forecasts prepared by the CEC's management. A reality check is performed while analyzing underlying assumptions taken by the management, as well as the management's track record in providing reliable budgets and forecasts.

4.6.1 Event Risk: Incorporating the risk of unforeseen events into the credit rating of a currency exchange company (CEC) is challenging due to the unpredictability of such occurrences. Event risks for CECs typically arise from external factors such as regulatory shifts, geopolitical tensions, currency crises, or natural disasters. These events can significantly affect the availability and movement of foreign exchange, the regulatory landscape, and the overall stability of the financial sector.

Additionally, internal risks such as system failures, operational disruptions, or strategic missteps could lead to significant financial or reputational damage. PACRA uses its analytical judgment to evaluate the likelihood of these events, their potential impact on a CEC's business, and the company's preparedness to mitigate such risks.

Information Required for Business Risk:

- Audited financial statements for the last three years and latest quarterly results
- Description of the CEC's business model and revenue streams
- Geographic and product segment breakdown
- Market share and competitive positioning details
- Key operational metrics (transaction volumes, branches, agent network)
- Trend analysis of revenue, transaction volume, and diversification

5. Financial Risk

5.1 Financial risk for CECs encompasses the potential vulnerabilities arising from their general operations, including exposure to credit defaults, liquidity shortfalls, market volatility, and quality of capital structure. These risks emanate from both internal financial practices and external economic conditions, making it essential to assess them objectively. This section provides a structured analysis of the key financial risks facing CECs and how effectively they are managed. PACRA's financial risk assessment offers an objective perspective, which, when combined with peer benchmarking, provides a comprehensive view of a CEC's financial standing.

5.2 Credit Risk: A CEC's encounter with credit risk can emanate from situations where funds or foreign currency are delivered prior to final and irrevocable settlement. Given the nature of their operations, CECs are less exposed to traditional forms of credit risk but must still be well-poised to manage potential counterparty defaults, particularly when dealing in larger foreign currency transactions. The ability of a CEC to mitigate credit risk is influenced by its policies for credit control, the credit ratings/reputations of its customers/counterparties, and the existence/quality of collateral or guarantees in larger transactions. While the regulatory framework prescribed by the State Bank of Pakistan emphasizes capital adequacy, internal controls, and exposure limits rather than explicitly defining credit risk categories, these operational features inherently give rise to credit exposures that are relevant for external credit assessment.

5.3 Liquidity Risk: Liquidity risk is a critical factor for CECs due to the necessity of maintaining sufficient cash reserves to meet foreign currency transaction demands. Fluctuations in foreign currency availability can strain liquidity. CECs must ensure that they have adequate liquidity to fulfill customer demands for currency

conversion, especially during periods of heightened volatility in the market. PACRA evaluates a CEC's liquidity management practices, including the balance between cash reserves, foreign currency holdings, liquid short-term investments, and its ability to access short-term funding, to ensure it can manage both routine operations and unexpected liquidity shocks.

5.4 Market Risk: Market risk for CECs will directly arise from the volatility of exchange rates. Interest rate movements and broader shifts in global currency markets would also indirectly affect CEC firms. Exchange rate fluctuations will directly impact the profitability of a CEC, especially in large-volume transactions or periods of sharp depreciation or appreciation in the domestic currency. In addition, global economic trends, such as monetary policy changes in key trading regions or shifts in foreign investor sentiment, can exacerbate market risk exposure. PACRA evaluates the hedging strategies and risk management frameworks employed by CECs to mitigate exposure to currency and interest rate fluctuations, ensuring that they have robust measures in place to handle volatility in the market volatility.

5.5 Capital Structure: PACRA analyzes capital structure to determine the CEC's reliance on external financing. The assessment of leverage in the capital structure is based on industry norms. A CEC's capital structure signals its financial stability and flexibility. Companies with strong capital reserves are better able to absorb operational shocks, navigate market disruptions, and meet regulatory capital requirements set by the State Bank of Pakistan. Moreover, highly leveraged firms would exhibit greater risk in times of market volatility and operational shocks. PACRA assesses the capital adequacy and leverage ratios to gain a view on the quality of the capital structure of CECs. CECs with less leverage (i.e., conservative capital structures) and strong financial management are typically viewed more favorably in terms of creditworthiness, as they are more likely to withstand periods of financial stress than those firms that are highly leveraged.

Information Required for Financial Risk:

- Foreign currency and settlement exposure breakdown
- Counterparty exposure metrics (banks, correspondents, clients)
- Details on provisions, write-offs, and credit controls
- Collateral/guarantee documentation for large transactions
- Related party exposures and contingent liabilities
- Notes on funding sources and access to short-term liquidity

Credit Rating

Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Scale	Long-Term Rating
AAA	Highest credit quality. Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA AA-	Very high credit quality. Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	High credit quality. Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	Good credit quality. Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	Moderate risk. Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	High credit risk. A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	Very high credit risk. Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Scale	Short-Term Rating
A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions. Liquidity may not be sufficient.

Rating Modifiers | Rating Actions

<p>Outlook (Stable, Positive, Negative, Developing)</p> <p>Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business / financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.</p>	<p>Rating Watch</p> <p>Alerts to the possibility of a rating change subsequent to, or, in anticipation of some material identifiable event with indeterminable rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating watch may accompany rating outlook of the respective opinion.</p>	<p>Suspension</p> <p>It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.</p>	<p>Withdrawn</p> <p>A rating is withdrawn on a) termination of rating mandate, b) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults, or/and e) PACRA finds it impractical to surveil the opinion due to lack of requisite information.</p>	<p>Harmonization</p> <p>A change in rating due to revision in applicable methodology or underlying scale.</p>
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Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening. Rating actions may include "maintain", "upgrade", or "downgrade".

Note: This scale is applicable to the following methodology(s):

a) Broker Entity Rating	e) Holding Company Rating
b) Corporate Rating	f) Independent Power Producer Rating
c) Debt Instrument Rating	g) Microfinance Institution Rating
d) Financial Institution Rating	h) Non-Banking Finance Company

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